Office of Chief Counsel
Internal Revenue Service

memorandum

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CJSantaniello 149413-01

date: SEP 1[illegible] 2001

to: Group Manager Tom Lynch, Group 1462, Rochester, NY
Attn: Revenue Agent Michael Fox, Group 1462, Syracuse, NY

from: Associate Area Counsel, LMSB, Area 1 (LM:FS:HAR)

ubject: **Large Case Advisory Opinion -** [redacted]

This memorandum responds to your request for assistance dated August 27, 2001. This memorandum should not be cited as precedent.

In your memorandum, you request our legal advice regarding whether the Service may disclose certain third-party return information to the taxpayer under audit. For the reasons set forth below, the return information may be disclosed under the provisions of I.R.C. § 6103(h)(4)(B)[1/] and 6103(h)(4)(C), but only to the extent necessary to advise the taxpayer of the amounts of the proposed adjustments and the basis therefor.

Issue

Whether tax return information of numerous TEFRA entities involved in a $[redacted] transaction with [redacted]. may be disclosed to [redacted] during the audit of [redacted]'s return for the year of the transaction. **U.I.L. No. 6103.11-00**

Facts

In [redacted], [redacted] entered into a Master Restructuring Agreement (the Agreement) with respect to [redacted] purchase power contracts (the power contracts) held by [redacted] TEFRA partnerships. In the Agreement, [redacted] agreed to pay $[redacted] and [redacted] shares of its common stock to the partnerships as consideration for the partnerships' agreement to terminate and/or restate the power contracts.

Immediately after entering into the Agreement, [redacted] wire transferred $[redacted] to an account in its name at [redacted]. According to [redacted], the funds were immediately transferred to an account established by the

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[1/] All statutory section references are to the Internal Revenue Code in effect during the taxable years at issue.

[redacted], representing the [redacted] TEFRA entities. The funds were thereafter allocated and disbursed to the partnerships or their designees. [redacted] was never informed regarding the manner in which the proceeds were allocated among the individual partnerships.

The revenue agent is now considering an issue regarding the deductibility of the payments made by [redacted] to the partnerships. According to the revenue agent, the portion of the $[redacted] disbursed to the partnerships that restated the contracts may not be currently deductible, while the portion disbursed to partnerships that terminated the contracts are deductible.

The revenue agent recently inspected the tax returns filed by the [redacted] partnerships. These returns reflect that [redacted] of the [redacted] entities restated their contacts, while the remaining [redacted] terminated their contracts. The returns further establish that of the $[redacted] paid by [redacted], $[redacted] was disbursed to the [redacted] partnerships that restated the contracts. [redacted] remains unaware regarding how the $[redacted] was allocated among the [redacted] partnerships.

Discussion

Section 6103(a) provides that, except as otherwise authorized by the Code, no officer or employee of the United States shall disclose any return or return information obtained by him in any manner in connection with his official duties. Church of Scientology of California v. IRS, 484 U.S. 9 (1987). In connection with your request for assistance, we discuss below several statutory exceptions under which the revenue agent could possibly disclose the return information of the [redacted] partnerships to [redacted].

Section 6103(c) provides that the Secretary may disclose the return or return information of any taxpayer to such person or persons as the taxpayer may designate in a request for or consent to such disclosure. Such disclosures are generally made pursuant to a Form 8821, Tax Information Authorization, signed by the taxpayer. In this case, the revenue agent could attempt to obtain Forms 8821 from the Tax Matters Partner for each partnership, authorizing the Service to disclose to [redacted] the tax treatment of the payments received by the partnerships. Considering, however, the shroud of secrecy placed over the transaction by the partnerships, it is highly unlikely that any would consent to the disclosure of the information to [redacted].

Another statutory exception to the general rule of nondisclosure appears in 6103(h), which specifically authorizes disclosure of certain tax returns and return information in judicial or administrative proceedings. Subparagraphs (B) and (C) of section 6103(h)(4) establish "item" and "transaction" tests under which returns and return information of taxpayers who are not parties to such proceedings may be disclosed in the proceedings. Under section 6103(h)(4)(B), a third party's return information may be disclosed only "if the treatment of an item reflected on such [third party's] return is **directly related** to the resolution of an issue in the proceeding." (emphasis added) Under section 6103(h)(4)(C), such information may be disclosed if its "directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which **directly affects** the resolution of an issue in the proceeding." (emphasis added) Sections 6103(h)(4)(B) and 6103(h)(4)(C). The "item" and "transactional relationship" tests appearing in sections 6103(h)(4)(B) and 6103(h)(4)(C) do not require that the disclosure be necessary to the resolution of the proceeding, but only that it affect the resolution of the issues in the proceeding. First Western Government Securities v. United States, 578 F. Supp. 212, 218 (D. Colo. 1984), aff'd, 796 F.2d 356 (10th Cir. 1986).

The term "administrative proceeding" is not defined in section 6103(h)(4) or elsewhere in the Code. The Service's position, however, is that the term includes "any proceedings regarding proposed or actual actions against a person(s) which are enforceable under agency laws or regulations." See I.R.M. 1.3.22.19(3).

In First Western, the district court, and eventually the Tenth Circuit, held that an audit constitutes an administrative tax proceeding within the meaning of section 6104(h)(4). According to the district court in First Western, the disclosure of return information relevant to an audit is consistent with the mandate in Treas. Reg. § 601.105(c)(2)(ii), which provides that a revenue agent should "prepare a complete examination report [RAR] fully explaining all proposed adjustments" to be provided to the taxpayer with his "30-day letter." Id, at 218. See also Nivens v United States, 88-1 U.S.T.C. ¶ 9199 (D. Kan. 1987); Balanced Financial Management, Inc. v. Fay, 662 F. Supp 100 (D. Utah 1987).

In Mallas v. United States, 993 F.2d 1111 (4th Cir. 1993), however, the Fourth Circuit disagreed with the conclusion reached in First Western, holding that an audit is not an administrative proceeding described in section 6103(h)(4). In Mallas, the court

characterized the Tenth Circuit's opinion in First Western as "analytically unsatisfying" and refused to follow it. 993 F.2d at 1123.

This issue has not, however, been previously considered by the Second Circuit, to which an appeal of this issue would lie. Regardless, the National Office believes that the Fourth Circuit's opinion in Mallas is incorrect and should not be followed. Accordingly, the revenue agent may disclose to [redacted] the identity of the partnerships that restated the contracts and the amounts received by those partnerships. He should, however, avoid making any disclosures other than those required to adequately inform [redacted] of the adjustments and the basis for those adjustments.

As we believe that an audit does constitute an administrative tax proceeding within the meaning of section 6103(h)(4), it appears that the "item" and "transactional relationship" tests in subsections (h)(4)(B) and (h)(4)(C) are satisfied in this case. As discussed above, at issue in the audit is the deductibility of the $[redacted] paid by [redacted]. This issue turns on several items of return information, including which partnerships restated the contracts, the amounts received by those partnerships, and the tax treatment claimed by those partnerships are all essential to the resolution of whether the payments are deductible by [redacted]. Because these items (1) directly relate to the resolution of an issue in the proceeding, section 6103(h)(4)(B), and (2) directly relate to a transactional relationship between [redacted] and the partnerships which directly affects the resolution of an issue in the proceeding, section 6103(h)(4)(C), they may be disclosed to [redacted].

The final exception in section 6103(a) appears in section 6103(k)(6). Under that section, an internal revenue officer or employee may, in connection with his official duties relating to any audit disclose return information to the extent that such disclosure is necessary in obtaining information, which is not otherwise reasonably available, with respect to the correct determination of tax liability. Section 6103(k)(6) does not authorize disclosure of the taxpayer's tax return itself. In Mallas, the Fourth Circuit stated that "Congress intended to address disclosures during audits and other investigations principally, if not exclusively, through section 6103(k)(6)." Mallas, 993 F.2d at 1124. The court further espoused that section 6103(k)(6) and its accompanying regulations strictly limit investigative disclosures to obtain information not otherwise reasonably available. Id.

In this case, we do not believe that the desired disclosures are authorized by section 6103(k)(6). Disclosures under that section are normally made to third parties to obtain information during an audit of the taxpayer whose return information is being disclosed. This case, however, involves the opposite situation, as it is the third parties' (the partnerships') return information that is to be disclosed to the taxpayer ([redacted].

Based on the language of section 6103(k)(6), the Service may make disclosures of third parties' return information to a taxpayer under audit "to the extent that such disclosure is necessary in obtaining information...with respect to the correct determination of tax [or] liability for tax." The statute was not drafted in terms of disclosures relating to any particular type or class of taxpayer. Although it arguable that disclosure of the partnerships' return information to [redacted] is necessary to fully develop the issue of whether the $[redacted] is deductible, any such argument is not persuasive. The issue of whether [redacted] may deduct the payments to the partnership can certainly be developed without making the disclosures to [redacted]. In fact, disclosure is only necessary to fully apprize the taxpayer of any adjustments and, more specifically, the reasons for those adjustments.

Conclusion

Although a consent waiver under section 6103(c) would avoid any legal arguments regarding the propriety of the disclosures, it does not appear to be a realistic possibility in this case. Additionally, section 6103(k)(6), involving investigative disclosures, is an inappropriate basis for disclosing the return information to [redacted]. Therefore, any disclosures of the partnerships' return information should be based exclusively on the provisions of sections 6103(h)(4)(B) and 6103(h)(4)(C) and only to the extent necessary to advise [redacted] of the adjustments and the basis therefor.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our

views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later.

Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

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By: _____
CARMINO J. SANTANIELLO
Attorney